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Nick McDonald is a leading independent trader with a global following via the company he founded, www.tradewithprecision.com. A specialist in technical trading strategy for any market and any time frame, Nick possesses a unique approach to modern technical trading which forms the basis of the strategies that he teaches. Nick is in high demand as a speaker on the global trading circuit with speaking engagements on multiple continents each and every year.

The Path to Trading Success

PART 4: TECHNICAL ANALYSIS VS. TRADING STRATEGY

If you have been following this series of articles from the start hopefully by now you have taken the time and effort to thoroughly assess whether you are better suited to swing or day trading and assess which market(s) best suit your personality and lifestyle. The next logical step is to learn about technical analysis and equip yourself with the tools and techniques necessary to profit from the markets. Unfortunately it's this step which is the cause of most aspiring traders' downfall.

THE TYPICAL TRADERS JOURNEY

Let's follow the typical path of a new trader (we will call him Bob). Bob is looking to make some extra income and has heard about using technical analysis to trade the stock market. He decides to find out more so visits his local bookstore and buys a book about technical analysis. Bob is amazed and excited about this whole new world which has been opened up to him. He learns about OHLC bars, trend lines, support and resistance and double bottoms/tops.

Bob believes he has found the hidden secrets to the market's riches. So he applies what he has learnt in the markets and before long he has lost a substantial portion of his trading capital. He rationalises this by believing he doesn't have enough knowledge about technical analysis and therefore decides to learn additional technical analysis tools and techniques. This time he learns about candlesticks and memorises 25 candlestick patterns and their names. He also learns about Elliott Wave and ascending/descending triangles.

He tops up his account and resumes trading. Once again he loses a substantial amount of his capital. Again he believes it's his lack of knowledge which is the cause of his unprofitable trading and therefore he must learn even more technical analysis tools in order to succeed. This time he learns about Gann, Fibonacci, pivot points, pitchforks and Gartley patterns.

Needless to say Bob continues on this merry-go-round until he finally loses all his trading capital and stops trading forever.

Bob has made a very common, and very critical, error. He doesn't realise that technical analysis and a trading strategy are two very different and separate aspects of trading.

Technical analysis and a trading strategy are two very different aspects of trading.

AS SIMPLE AS BAKING A CAKE

The simplest way we have found to explain the difference between the two is to use the analogy of a baker wanting to bake a chocolate cake, which is synonymous to a trader wanting to make a profit.

In order to achieve the same perfect chocolate cake (ie flawless trade) each and every time the baker (ie trader) will use a recipe (ie written strategy with checklist). The recipe is basically a set of rules that the baker must follow if they are to achieve their desired outcome of a perfect chocolate cake. The recipe will tell the baker which ingredients are required, the quantities of those ingredients and also how those ingredients are to be combined and baked in order to achieve the desired outcome of a perfect chocolate cake.

Relating that analogy back to trading, technical analysis would be the ingredients and trading strategy would be the recipe. Bob was learning every sort of ingredient possible but he had no recipe on how he should mix them together, in what quantities or in what order. What would you get if you randomly mixed eggs, flour, cocoa, butter, milk and sugar and expected to get a chocolate cake from it? Most likely an inedible mess! Bob was getting similarly poor results because he was randomly mixing various technical analysis techniques together hoping to make a profit.

Without a written trading strategy your chances of success over the long term are close to zero. So what then should have Bob done when designing a trading strategy?

MODERN DAY TRADING STRATEGY

A trading strategy should have three components:

1. Entry criteria
2. Risk Management
3. Trade Management

We will cover risk and trade management in later articles so for now let's focus on entry criteria.

HOW MANY TECHNICAL INGREDIENTS?

It is impossible to bake a chocolate cake with only one or two ingredients and neither can you design a high probability trading strategy with only one or two technical ingredients. At Trade With Precision we recommend that a strategy should contain a minimum of 8 technical ingredients.

If you were to use eight ingredients you should be able to make an average tasting chocolate cake, but increase that to 15 ingredients and you should be about to (with a bit of experience) make a truly delicious chocolate cake. Trading is no different. You can design an average trading strategy with eight technical ingredients or you could design a truly great strategy with 15 ingredients. However, be careful not to overcomplicate your strategy by having too many technical ingredients. Between eight and 20 technical ingredients is usually the optimal number.

TRADING STRATEGY FORMAT

Recipes are written down so they are never forgotten and can be flawlessly followed consistently. A trading strategy is no different.

We also prefer to divide our checklists into an essential checklist and a bonus checklist. The essential checklist will contain all of those technical factors which absolutely must be present before we would even consider a set up as being valid. Then the bonus factors are those technical ingredients which are "nice to have". If they are present then that is great as it will increase the probability of the trade being profitable but if they aren't present then it won't prevent us from entering a trade.

Typically we scan the markets looking for trades that loosely match our essential checklist. At the end of the scan if we have for example five such set ups then we will check them off more closely to ensure they meet all the essential ingredients before then applying the bonus checklist. We are then able to rank those five set ups in order from highest probability to lowest probability of success based on how many bonus checklist ingredients they meet. This will allow us to decide which of the five set ups (if any) we wish to place orders for.

Some people wrongly believe that having a trading strategy with multiple technical ingredients is difficult and confusing when in reality it doesn't need to be. Assess the following short trading checklist:

1. Trade with the trend direction.
2. Look for a break of resistance (a level of resistance is defined by a price level which has been tested a minimum of three times).
3. Ensure price and indicators converge on the break.

Can you see how that is actually no more difficult than saying, add flour, mix in milk and then add cocoa. Both are simple once you have a bit of experience and know how to do it! How many one step recipes have you ever come across in your time? Trading strategies are no different.

FLAWLESS EXECUTION

The job of the trader now becomes one of ensuring that they flawlessly execute time and again versus their checklists. By following their checklists they will produce flawless trades, just as the baker produces a perfect chocolate cake each time they follow their recipe.

One difference worth mentioning in trading is that a flawlessly executed trade does not guarantee a profitable result from that trade, whereas a flawlessly executed recipe would result in a perfect chocolate cake. To grasp this concept you must understand probabilities in trading and how to think like a trader – both topics for later in the series.

WHAT'S NEXT

Now that you understand the vital difference between technical analysis and trading strategy over the next three articles we will cover which technical ingredients we use in all of our trading strategies and checklists.